

For information

Legislative Council Panel on Financial Affairs

**Review of the Qualifying Criteria under
the Securities and Futures (Professional Investor) Rules**

PURPOSE

In 2018 when the Securities and Futures (Professional Investor) Rules (Cap. 571D) (“PI Rules”) administered by the Securities and Futures Commission (“SFC”) were under amendment, some Legislative Council (“LegCo”) members raised comments on the existing criteria for an investor to qualify as a professional investor (“PI”) under the PI Rules. In this connection, the SFC has undertaken to review the monetary thresholds under the PI Rules. This paper reports the outcome of the review of the monetary thresholds under the PI Rules and related issues, as well as the SFC’s recommendations.

BACKGROUND

PI Rules

2. The PI Rules were first promulgated in 2003 pursuant to the SFC’s rule making power under section 397 of the Securities and Futures Ordinance (“SFO”). The rules prescribed certain categories of persons as PIs, including individuals and corporations, as distinct from retail investors¹. An investor’s loss absorption ability (i.e. having the necessary resources to protect his/her own interest) was a key factor that the SFC took into account. Under the existing PI Rules, the following persons are prescribed as PIs:

¹ Investors who are not institutional investors and who are not eligible to be prescribed as PIs under the PI Rules represent the vast majority of the investing public and are conventionally referred to as retail investors.

- (a) any individual having a portfolio² of not less than \$8 million with
 - (i) the individual's own account;
 - (ii) any of the individual's associates³ on a joint account;
 - (iii) the individual's share of a portfolio on a joint account with person(s) other than the individual's associate; and/or
 - (iv) a portfolio of a corporation which has as its principal business the holding of investments and is wholly owned by the individual;
- (b) any corporation or partnership having a portfolio of not less than \$8 million or total assets of not less than \$40 million;
- (c) any trust corporation with total assets of not less than \$40 million; or
- (d) any corporation which has as its principal business the holding of investments and which is wholly owned by (a), (b), (c) above, and/or a professional investor within the meaning of paragraphs (a), (d), (e), (f), (g) or (h) of the definition of "professional investor" in Schedule 1 to the SFO.

3. As PIs are generally regarded as having sufficient resources to protect their own interests, certain requirements of the SFO and the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct") imposed on intermediaries may be dis-applied when intermediaries deal with PIs –

- (a) Section 103 of the SFO prohibits the issuance or possession of unauthorized advertisements, invitations or documents relating to investments, unless authorized by the SFC. The prohibition does not apply to the issuance or possession of advertisements etc. that is intended to be disposed of only to PIs. This exemption allows access by PIs to products not authorized by

² The term "portfolio" is defined under the PI Rules to mean a portfolio comprising cash, bank deposits, securities, or a combination of these assets.

³ The term "associate" is defined under the PI Rules as the spouse or any child of an individual.

the SFC (commonly known as “private placement products”)⁴ which are not available to retail investors.

- (b) Section 174 of the SFO prohibits an intermediary from making or offering to make a number of agreements, including selling or purchasing securities, during or as a consequence of an unsolicited call. The prohibition does not apply to unsolicited calls made to PIs.
- (c) Section 175 of the SFO prohibits the offer of securities that are not accompanied by an offering document containing relevant information. The prohibition does not apply to an offer made to PIs. The offering and marketing documents of private placement products are not subject to the SFC’s review.
- (d) Paragraph 15.4 of the Code of Conduct sets out the requirements that could be waived when intermediaries deal with (i) corporate PIs that have been assessed to have appropriate corporate structure and investment process and controls (referred to in this paper as “sophisticated corporate PIs”); and (ii) institutional PIs that fall within the meaning of paragraphs (a) to (i) of the definition of “professional investor” in Schedule 1 to the SFO. These requirements include the need to establish a client’s financial situation, investment experience and investment objectives and the requirement to ensure suitability of a recommendation or solicitation.
- (e) Paragraph 15.5 of the Code of Conduct sets out the requirements that could be waived when intermediaries deal with PIs. These requirements are administrative in nature, including the need to provide general information about the intermediary and to confirm essential features of a transaction after execution.

The review

4. In June 2018, the LegCo deliberated on the amendments to the PI Rules proposed by the SFC to expand (i) the types of individuals and corporations that are to be regarded as PIs; and (ii) the records which may

⁴ Examples include privately placed shares of listed companies, unauthorized funds (e.g. hedge funds and private equity funds), unauthorized structured products (e.g. accumulators) and unauthorized debentures (e.g. non-retail bonds).

be considered in ascertaining whether a person is a PI. Following negative vetting by the LegCo, the amendments came into operation on 13 July 2018.

5. While considering the amendments, some LegCo members commented on the criteria for an investor to qualify as a PI, in particular with respect to the monetary thresholds adopted, under the PI Rules. In response to LegCo members' comments, the SFC undertook to review the monetary thresholds under the PI Rules in 2019. In August 2019, the SFC appointed an external consultant to assist in the review. The SFC also engaged the Investor and Financial Education Council ("IFEC") to gauge investors' views on the monetary thresholds of the PI Rules. Furthermore, the consultant took the opportunity to look into some related issues, including whether new qualifying criteria for PIs should be introduced.

REVIEW OUTCOME

6. Upon completion of the review in May 2020, the SFC concluded that the PI Rules are fit for purpose and does not recommend changes to the qualifying criteria and calculation basis of the existing monetary thresholds under the PI Rules. The SFC does not recommend the adoption of other criteria for qualifying PIs either. Details of the findings and recommendations of the consultant, as well as the SFC's view, are set out below.

I. Monetary thresholds

7. In considering the effectiveness of the current monetary thresholds in providing sufficient protection for investors, a few LegCo members suggested that the level should be adjusted upward to keep up with market changes so that the protection for investors could be maintained.

International comparison

8. In Hong Kong, the eligibility of PIs is primarily determined by the monetary criteria stipulated under the PI Rules (see paragraph 3). According to the international comparison conducted by the SFC's

consultant (see Annex A), tests based on monetary criteria are similarly adopted by the comparable jurisdictions as the singular or primary method for distinguishing investors who are considered to be eligible to participate in private capital markets (generally referred to in this paper as “professional investors”). In sum, the portfolio threshold for individual PIs of Hong Kong is higher than the financial instrument portfolio threshold in the United Kingdom and is comparable to the net financial assets threshold in Singapore. As regards the portfolio threshold for a corporation to qualify as a PI, the United Kingdom’s requirement is substantially lower than Hong Kong’s. For the total assets threshold for corporations, Hong Kong’s total assets threshold is largely in line with the United States and Australia.

9. In this connection, the consultant considered that the current level of the monetary thresholds under the PI Rules is largely in line with the comparable jurisdictions.

Investor protection

10. From investor protection perspective, the monetary thresholds perform the gatekeeping function of the PI regime, while the suitability obligations imposed on intermediaries also play a key role in the regime. When dealing with a PI who has access to private placement products, intermediaries are required to discharge the same suitability obligations under the Code of Conduct as with retail investors⁵. The specific requirements are:

- (a) An intermediary should ensure the suitability of a recommendation or solicitation for a client is reasonable in all the circumstances. This obligation was extended in 2016 to cover intermediaries dealing with PIs.
- (b) Since 2019, when an intermediary executes a transaction of a complex product for a client without making any solicitation

⁵ With narrow exceptions when intermediaries deal with:

- (a) institutional PIs such as banks, insurance companies and regulated financial intermediaries; and
- (b) sophisticated corporate PIs who have been assessed to have appropriate corporate structure and investment process and controls.

or recommendation, the intermediary is required to ensure that the transaction is suitable for the client in all the circumstances. In addition, the intermediary is required to provide (i) sufficient information to enable the client to understand the complex product; and (ii) warning statements to the client.

11. It is noted that the suitability requirements are not applicable to PIs in some comparable jurisdictions such as Singapore and Australia (see **Annex B**). The consultant is of the view that individual and corporate PIs in Hong Kong are covered by the full range of investor protections.

Correlation with property prices

12. Some LegCo members opined that given that an investor holding a residential property in Hong Kong could easily become a PI, the monetary thresholds under the PI Rules should be adjusted upward in view of the escalating property prices in Hong Kong.

13. Although property prices in Hong Kong have risen fivefold over the past 20 years, the consultant considered that any change in the monetary thresholds should be considered based on a comprehensive array of factors, including international regulatory developments, economic and financial trends (e.g. gross domestic product and consumer price index), local market conditions, rather than a single factor of property prices which tend to fluctuate for a wide range of reasons.

Stakeholders' view

14. As part of the review, the consultant interviewed market participants (including retail brokers, retail banks and private banks) to gauge their views on the PI Rules. Interviewees expressed little concern about the \$8 million portfolio threshold and some of them indicated that the \$40 million total assets threshold for corporations is not widely used in practice.

15. The SFC, with the assistance of the IFEC, conducted a number of focus group discussions and one-to-one interviews to solicit investors' views on the PI Rules. Most interviewees do not have strong views on the \$8 million portfolio threshold as they consider that protection for investors rests heavily on the suitability obligations that an intermediary owe to them. They also consider that adjusting the threshold does not mean much as it only represents a prerequisite to access a wider range of investment products. In the annual retail investor survey conducted by the IFEC, among a total of 826 retail investors who responded to the survey, most respondents who are aware of the PI regime consider the \$8 million portfolio threshold appropriate.

SFC's view

16. Since the monetary thresholds in place in 2003, the investor protection afforded to PIs have been strengthened by the expansion of the suitability obligations in 2016 and the introduction of a new suitability obligation for the execution of client-initiated transaction in complex products in 2019. The monetary threshold is more a prerequisite for ensuring that an investor has a certain level of loss absorption ability before the investor is permitted to invest in private placement products. As explained above, intermediaries providing services to PIs are still required to observe the suitability requirements.

17. In view of the above, and considering that the monetary thresholds in the PI Rules are largely in line with the comparable jurisdictions and are generally accepted by stakeholders, the SFC agrees with the consultant's recommendation that no change to the monetary thresholds is required.

II. Potential new criteria

Total assets criterion for qualifying individual investors

18. Some LegCo members noted that different asset classes are adopted for qualifying individuals (portfolio only) and corporations (portfolio and total assets) as PIs and questioned whether the calculation basis should be aligned.

19. The consultant does not recommend the adoption of the total assets criterion for individuals for the following reasons:

- (a) Residential properties may make up a considerable portion of the assets owned by an individual and the loan-to-value cap of residential properties could be more than 50%⁶.
- (b) The criterion may include illiquid and non-investment assets. Some industry participants found it difficult to obtain an accurate valuation of the assets owned by an investor.
- (c) The criterion is not commonly adopted in the comparable jurisdictions for individuals – only Australia has introduced it in its regime (see Table 1 at **Annex A**).

SFC's view

20. The SFC agrees with the consultant's recommendation. Considering the mortgage ratio and the difficulty in obtaining an accurate valuation of assets, the SFC finds that the total assets criterion is not suitable for Hong Kong.

Net assets criterion for qualifying individual and corporate investors

21. A LegCo member inquired whether liabilities should be considered in the calculation basis (i.e. the use of net assets instead of portfolio or total assets). While the net assets criterion is a stronger indicator of one's loss absorption ability than the portfolio and total assets criteria, there are operational difficulties and compliance cost concerns in obtaining information about the liabilities owed by an individual in Hong Kong.

22. For example, in Australia, a client is required to give the intermediary a certificate issued by a qualified accountant stating the amount of net assets the client owns. Such requirement would result in the client or intermediary incurring extra costs in classifying an investor as a PI. Taking the United States as another example, the consultant

⁶ Based on the data published by the Hong Kong Monetary Authority, the average loan to value ratio of residential properties in the past 10 years (up to February 2020) is 52.6%.

found that Hong Kong does not have similar regulatory requirements in place to make credit reports available for free or to require intermediaries to obtain information about a customer's net worth. As discussed above, for the assets criterion, industry participants found it difficult to obtain an accurate valuation of the assets owned by an investor.

SFC's view

23. In view of the above, particularly the operational difficulties that intermediaries may encounter, the SFC does not propose the adoption of the net assets criterion.

Non-financial metrics – Investment knowledge and experience

24. Some LegCo members suggested that investment knowledge and experience should be added as alternative criteria for individuals who do not meet the portfolio threshold of \$8 million. Some investor interviewees shared the view that there should be other measures to allow sophisticated investors with rich investment experience to become PIs.

25. Industry participants who met with the consultant had mixed views. Brokerage firms supported the introduction of investment knowledge and experience criteria with a view to expanding their PI client base. Private banks however indicated that they would not widely adopt these criteria even if they were introduced as individual investors are required to meet the minimum assets requirement (i.e. ranged from US\$3 million to US\$10 million for the private banks interviewed) in order to maintain private banking relationships with the banks.

SFC's view

26. The SFC does not propose to adopt non-monetary criteria for individuals to qualify as professional investors. The purpose of the qualifying criteria under the PI Rules is to ensure that only investors with a certain level of loss absorption ability would have access to private placement products, and this objective cannot be achieved by the adoption of non-monetary criteria.

RECOMMENDATION BY THE SFC

27. Having carefully considered the consultant's analysis and information gathered by the IFEC, and taking into account the regulatory approach and intermediaries' compliance costs in totality, the SFC has come to a view that the current monetary thresholds in the PI Rules for individuals and corporations do not require adjustment. The key considerations are:

- (a) The monetary thresholds reflect an investor's savings and loss absorption ability. They are simple and easy-to-interpret.
- (b) The existing monetary thresholds in Hong Kong are in line with those in the comparable jurisdictions.
- (c) An investor who meets one of the monetary thresholds in the PI Rules and qualifies as a PI is also protected by the suitability requirements set out in the Code of Conduct.
- (d) The market participants interviewed do not have strong views on the monetary threshold of \$8 million for an individual to qualify as a PI.
- (e) Most investor respondents who are aware of the PI regime consider the monetary threshold of \$8 million appropriate. Some see the suitability requirements as strong investor protection measures.
- (f) Suggested new monetary (gross / net assets) or non-monetary criteria (knowledge and experience) do not reflect an investor's ability to absorb loss and impose practical difficulties on intermediaries in their implementation.

28. The SFC will keep in view market and regulatory developments locally and internationally. It will also continue to work with the IFEC to enhance investor education surrounding the topic of PIs.

ADVICE SOUGHT

29. Members are invited to note the review outcome and the SFC's recommendation.

**Financial Services and the Treasury Bureau
Securities and Futures Commission
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Comparison of Monetary Thresholds of Hong Kong and Overseas Regimes

Table 1 – Comparison of qualifying criteria – Individuals

International comparison of qualifying criteria – Individuals (US\$'000)					
■ Annual income ■ Gross assets ■ Financial portfolio ■ Net worth ■ Non-monetary criteria used in combination with monetary criteria					
	HK	UK	SG	AU	US
	Professional investor	Elective professional client	Accredited investor	Wholesale client	Accredited investor
Monetary criteria/ thresholds	<p>~1,020 ▪ Portfolio size at the relevant date</p>	<p>~550 ▪ Financial instrument portfolio</p>	<p>~220 ▪ Income in the preceding 12 months</p> <p>~720 ▪ Financial assets (net of any related liabilities)</p> <p>~1,440 ▪ Net personal assets (value of primary residence not exceeding 50%)</p>	<p>~170 ▪ Gross income p.a. in the past two financial years</p> <p>~1,680 ▪ Net assets</p> <p>~6,700 ▪ Gross assets (have or control)</p>	<p>~200/300 ▪ Income (individual or joint with spouse) in two most recent years and has a reasonable expectation of reaching the same income level in the current year</p> <p>~1,000 ▪ Net worth (individual or joint with spouse) (excluding primary residence)</p> <p>Bill under review: To adjust the level of income and the amount of net worth for inflation every 5 years</p>
Non monetary criteria/ thresholds	N/A	<p>▪ 10 or more transactions of significant size per quarter over the four previous quarters</p> <p>▪ At least one year working experience in financial sector</p>	N/A	<p>Assessed by a licensee as having previous experience in using financial services and investing in financial products</p>	<p>▪ Bill under review: Individuals (a) registered or licensed with SEC or FINRA or an equivalent self-regulatory organization or (b) with qualifying knowledge and experience</p> <p>▪ Proposed amendments: To include natural persons who qualify based on (a) knowledge, experience or certifications or (b) "knowledgeable employee" of private funds</p>
Application rule	Single criterion	Meet at least 2 of 3 criteria (monetary and non-monetary) from above	Meet at least 1 from above	Meet at least 1 from above	Meet at least 1 of the monetary criteria from above

Table 2 – Comparison of qualifying criteria – Corporations

International comparison of qualifying criteria – Corporations (US\$'000)					
■ Annual income ■ Gross assets ■ Financial portfolio ■ Net worth ■ Non-monetary criteria used in combination with monetary criteria					
	HK	UK	SG	AU	US
	Professional investor	Elective professional client ("EPC")	Accredited investor	Wholesale client	Accredited investor
Monetary criteria/thresholds	~1,020 ▪ Portfolio size at the relevant date ~5,100 ▪ Total assets at the relevant date	~550 ▪ Financial instrument portfolio Large undertaking ("LU") ~22,000 ▪ Balance sheet total ~44,000 ▪ Net turnover ~2,200 ▪ Own funds	~7,200 ▪ Net assets	~170 ▪ Gross income p.a. in the past two financial years ~1,680 ▪ Net assets ~6,700 ▪ Gross assets (have or control)	~5,000 ▪ Total asset of corporation that is not formed for the specific purpose of acquiring the securities offered
Non-monetary criteria	NA	Elective professional client ("EPC") <ul style="list-style-type: none"> 10 or more transactions of significant size per quarter over the four previous quarters At least one year working experience in financial sector Large undertaking ("LU") NA	NA	<ul style="list-style-type: none"> Assessed by a licensee as having previous experience in using financial services and investing in financial products Financial services licensees Listed corporation 	NA
Application rule	Meet at least 1 from above	<ul style="list-style-type: none"> EPC: Meet at least 2 of 3 criteria (monetary and non-monetary) from above LU: Meet at least 2 of 3 monetary criteria from above 	Single criterion	Meet at least 1 from above	Single criterion

Table 3 – Comparison of the relevant qualifying criteria

Comparison of the relevant qualifying criteria			
Financial assets – Individuals (US\$'000)		Total assets – Corporations (US\$'000)	
	Calculation basis	Threshold	
HK	Financial portfolio *	1,020	HK
Comparable jurisdictions	UK	Financial instrument portfolio *	550
		As part of the three-part test for elective professional clients	
	SG	Financial assets	720
		Net of related liabilities	
HK	Total assets	5,100	HK
Comparable jurisdictions	US	Total assets	5,000
		AU	Gross assets (have/control) #
	UK		Balance sheet total
		As part of the three-part test for large undertakings	

* Also applicable to corporations
Also applicable to individuals

Source: The consultant's proprietary research

Exchange rates (as of 1 September 2019): USD/HKD = 7.84, EUR/USD = 1.10, USD/SGD = 1.39, AUD/USD = 0.67

Note: In considering various thresholds in the comparable jurisdictions, it is noted that the specific calculation method of each threshold varies. The overseas criteria that are the closest to Hong Kong's criteria have been adopted in drawing the comparison.

Comparison of Investor Protection Requirements of Hong Kong and Overseas Regimes

International comparison of investor protection requirements					
	HK	UK	SG	AU	US
Advisory transactions	Reasonable basis to ensure suitability of recommendations or solicitations	Reasonable basis to ensure suitability: (i) Meet the client's investment objectives (ii) The client could financially bear the investment risks (iii) The client has knowledge and experience to understand the risks involved	Reasonable basis to ensure recommendations made are appropriate	Reasonably be regarded as being in the best interests of the client for the advice provided	Reasonable basis to ensure customer-specific suitability Effective from 30 Jun 2020: Reasonable basis to believe that recommendations are in the best interest of a retail customer
Execution-only (non-advisory) transactions in complex products	Ensure suitability of transactions in complex products in all circumstances	The transaction is appropriate with regard to the client's knowledge and experience to understand the risks involved	N/A	N/A	N/A
Exemptions when dealing with relevant class of investors	<ul style="list-style-type: none"> ▪ No exemption for individual professional investors ▪ Exempt when dealing with a limited no. of sophisticated corporate professional investors that have appropriate corporate structure and investment process and controls 	Lighter investor protection requirements: <ul style="list-style-type: none"> ▪ Advisory transactions: Exemption on (i) for elective professional clients, and (i) and (ii) for per se professional clients ▪ Execution-only (non-advisory) transactions in complex products: Exempt when dealing with elective and per se professional clients 	Exempt when dealing with accredited investors	Exempt when dealing with wholesale clients	Customer-specific suitability: <ul style="list-style-type: none"> ▪ No exemption for accredited investors ▪ Exempt from when dealing with institutional investors with total assets ≥ US\$50M Best interest requirement: No exemption if the accredited investor is a retail customer

Source: The Code of Conduct – Hong Kong; the FCA Handbook – the United Kingdom; the Financial Advisers Act and the Financial Advisers Regulations – Singapore; the Corporations Act 2001 – Australia; the FINRA Rules and the Code of Federal Regulations – the United States

